



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-47-2014
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Margin and Capital Requirements for Covered Swap Entities

Summary: The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Housing Finance Agency (the agencies) are issuing a Notice of Proposed Rulemaking (NPR) and request for comment to implement Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These sections require the agencies to adopt rules jointly to establish capital requirements, and initial and variation margin requirements for all non-cleared swaps and non-cleared security-based swaps of dealers or major participants. Comments will be solicited on this NPR for 60 days following publication in the *Federal Register*.

Statement of Applicability to Institutions with Total Assets Under \$1 Billion: The thresholds and minimum transfer amount in the proposed rule are sufficiently high that the proposed rule should have little, if any, impact on the vast majority of community banks.

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FDIC-Supervised Banks (Commercial and Savings)

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[Notice of Proposed Rulemaking to Establish Margin and Capital Requirements for Covered Swap Entities](#)

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Highlights:

The proposed rule applies to the largest and most active participants in the over-the-counter derivatives market that have been designated by the U.S. Commodity Futures Trading Commission (CFTC) or the U.S. Securities and Exchange Commission (SEC) as swap dealers or major swap participants or security-based swap dealers or security based major swap participants. The NPR calls these firms "covered swap entities" Under the proposed rule:

- Covered swap entities (CSEs) would be required to post and collect initial and variation margin from other CSEs.
- CSEs trading with financial end users with material swaps exposures (notional of \$3 billion) must post and collect initial margin if the amount of required initial margin exceeds \$65 million.
- CSEs would be required to post and collect variation margin from all financial end users if the amount of required variation margin exceeds \$650,000.
- Most community banks' swaps activities are in amounts too small to be affected by the proposed rule.
- The proposed rule does not require CSEs to collect margin from commercial end users.
- The proposal establishes minimum quality standards for acceptable initial and variation margin collateral. It also establishes minimum safekeeping standards for initial margin collateral posted by CSEs and counterparties to assure collateral will be available to support the trades if defaults occur.
- Only new trades entered into after the proposed effective dates would be subject to the proposed requirements. These dates range from December 2015 to December 2019.

Margin and Capital Requirements for Covered Swap Entities

Background

The Dodd-Frank Act Swap Reform. Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Title VII) amended the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934 (the Exchange Act) to establish a comprehensive regulatory framework for derivatives that meet the Title VII definition of swaps and security-based swaps (collectively, swaps).¹ Specifically, Sections 731 and 764 of the Dodd-Frank Act require the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Housing Finance Agency (the agencies) to adopt rules jointly to establish capital requirements, and initial and variation margin requirements for swaps of an insured depository institution or other entity that (1) is supervised by the prudential regulators; and (2) is registered with the U.S. Commodity Futures Trading Commission (CFTC) or the U.S. Securities and Exchange Commission (SEC) as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant on all non-cleared swaps and non-cleared security-based swaps. This is being done to offset the greater risk to such entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

2011 NPR: In May 2011, the agencies initially published proposed rules for swap margin requirements (2011 proposal) to implement Sections 731 and 764 of the Dodd-Frank Act. The agencies received more than 100 comments from banks, asset managers, commercial end users, and trade associations. The CFTC also proposed margin requirements in May 2011 for swap entities it supervises, and the SEC proposed such requirements for entities subject to its supervision in November 2012.

2013 International Framework on Margin: In July 2012, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published a proposed framework for margin requirements on non-cleared swaps with the goal of creating an international standard for margin requirements on non-cleared swaps. Following the release of the proposed international framework, the agencies re-opened the comment period on the 2011 proposal to allow for additional comment. The proposed international framework was subject to public comment before it was finalized by the BCBS and IOSCO in September 2013 (the 2013 international framework).²

The agencies reviewed the comments received on the 2011 proposal, as well as the 2013 international framework, and determined that changes to the 2011 proposal were warranted. In light of those changes, the agencies developed the attached NPR, which supersedes the 2011 proposal. The NPR would establish minimum margin requirements for the swaps of an insured depository institution or other entity that (1) is supervised by the prudential regulators; and (2) is registered with the CFTC or the SEC as a swap dealer, major swap participant, security-based

¹ “Swaps” are defined in the CEA to include interest rate swaps, foreign exchange swaps, commodity-based swaps, and broad-based credit swaps. “Security-based swaps” are defined in the Exchange Act to include single-name and narrow-based credit swaps and equity-based swaps.

² See BCBS and IOSCO “Margin requirements for non-centrally cleared derivatives,” (September 2013), available at <http://www.bis.org/publ/bcbs261.pdf>.

swap dealer, or major security-based swap participant (covered swap entities and, herein “CSEs”). The agencies are requesting comment on the NPR for a 60-day public comment period.

The Proposed Rule

The agencies are proposing to adopt a risk-based approach that would establish initial and variation margin requirements for covered swap entities and their counterparties. Consistent with the statutory requirement, the proposed rule would help ensure the safety and soundness of the CSE and be appropriate for the risk to the financial system associated with non-cleared swaps held by CSEs. The proposed rule considers the risk posed by a CSE’s counterparties in establishing the minimum amount of initial and variation margin the CSE must exchange with its counterparties. The proposed rule would be consistent with the 2013 international framework.

To implement this risk-based approach, the proposed rule distinguishes among four types of swap counterparties: (i) counterparties that are CSEs; (ii) counterparties that are financial end users with a material swaps exposure; (iii) counterparties that are financial end users without a material swaps exposure; and (iv) other counterparties, including nonfinancial end users, sovereigns, and multilateral development banks.³ These categories reflect the agencies’ belief that risk-based distinctions can be made among these types of swap counterparties.

The proposed rule’s initial and variation margin requirements generally apply to the collection, as well as the posting, of minimum initial and variation margin amounts by a CSE from and to its counterparties. This proposal represents a refinement to the agencies’ original collection-only approach to margin requirements based on consideration of comments made on the 2011 proposal and the 2013 international framework. The agencies believe that imposing requirements with respect to the minimum amount of initial and variation margin to be collected is a critical aspect of offsetting the greater risk to the CSE and the financial system arising from the CSE’s non-cleared swap exposure. However, the agencies also believe that requiring a CSE to post margin to other financial entities could forestall a build-up of potentially destabilizing exposures in the financial system. Therefore, the proposed rule’s approach is designed to ensure CSEs transacting with other swap entities and with financial end users in non-cleared swaps will be collecting and posting appropriate minimum margin amounts with respect to those transactions.

Under the proposal, a CSE’s collection of margin from “other counterparties” that are commercial end users remains a matter for the judgment of the covered swap entity, and does not represent a change from current margining practice. That is, under the proposed rule, a CSE is not required to collect initial and variation margin from a commercial end user. However, a CSE should continue collecting initial or variation margin as the CSE determines necessary as a component of its overall credit risk management of the swap entity’s exposure to the customer.

Under the proposed rule, a CSE would be required to calculate the required amount of initial margin using one of two alternatives. The CSE may calculate minimum initial margin requirements through the use of a standardized “lookup” table (Appendix A to the proposed rule) that specifies the minimum initial margin that must be posted or collected as a percentage of a swap’s notional amount. A CSE also may calculate minimum initial margin requirements through the use of an internal model that meets certain requirements and is approved by the CSE’s primary regulator. In addition, the proposed rule would require that the internal model used in the calculation of the margin requirement be at least as conservative as those used by swap clearinghouses.

³ See § __.2 of the proposed rule for the various constituent definitions that identify these types of swap counterparties.

The proposed rule also permits a covered swap entity to adopt a maximum threshold amount of \$65 million, below which it need not collect or post a minimum amount of initial margin for swaps with counterparties that are (1) swap entities; or (2) financial end users with material swaps exposures (notional \$3 billion). The threshold would be applied on a consolidated basis to both the covered swap entity and its counterparty.

For transactions with (1) financial end users without material swap exposure or (2) commercial end users, the proposed rule does not specify a minimum amount of initial margin that must be collected or posted. The agencies intend to maintain the status quo with respect to the way that banks interact with commercial end users.

The proposed rule limits the types of collateral eligible to satisfy the initial margin requirements to immediately available cash funds; obligations of, or fully guaranteed by, the United States; and senior debt obligations of government-sponsored entities and other high-quality collateral. Other than immediately available cash funds, all types of eligible collateral are subject to haircuts for determining the value for initial margin purposes. The proposed rule also would require the CSE and the CSE counterparty to segregate and hold the collateral posted as initial margin in a non-affiliated custodian account subject to a legally enforceable agreement that prohibits the custodian from re-using or re-hypothecating such collateral. The segregation requirement is based on a preliminary conclusion by the agencies that requiring initial margin to be segregated is necessary to offset the greater risk to the CSE and the financial system arising from the use of uncleared swaps and protect the safety and soundness of the counterparties. Variation margin must be settled daily, and the payment must be made in cash. The proposed rule places no restrictions on the use of variation margin by the receiving counterparty.

The implementation of the proposed rule begins in December 2015 for variation margin. Initial margin between large dealer CSEs is required beginning in December 2015 with other institutions phased in by December 2019. The variation margin and initial margin requirements only apply to new trades booked after the effective dates.

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